1000 RELEVANT LAW

Subsequent sections of this manual will cover specific, detailed aspects of the apportionment and allocation procedures applicable to multistate businesses. In order to set those rules into the proper perspective, this section of the manual is intended to provide an overall understanding of the framework of the California Bank and Corporation tax system as it relates to multistate businesses.

In order for a state to have jurisdiction to tax a bank or corporation, that bank or corporation must have a minimum connection or "nexus" within the state. Since this is a prerequisite to tax, this section of the manual will begin with a discussion of nexus, followed by coverage of the additional jurisdictional limitations imposed by Public Law 86-272. Once jurisdiction to tax has been established, a discussion of the distinction between the California Corporate Franchise and Income taxes is the logical next step. The concept of commercial domicile and its affect on many of California's sourcing rules will then be introduced. Finally, the Revenue and Taxation Code provisions dealing with combination, apportionment and allocation will be identified and summarized.

Reviewed: December 2002

1100 NEXUS AND A STATE'S RIGHT TO TAX

The term "nexus" refers to the level of activity or presence that a taxpayer has established within a taxing jurisdiction. In order for a state (or other taxing jurisdiction) to impose a tax, the Due Process and Commerce Clauses of the U.S. Constitution require that the taxpayer have a certain minimum connection, or nexus, within the state. The point at which sufficient nexus is reached has not been precisely defined, but a number of court cases have addressed the issue and have provided some parameters.

For many years, the standard for establishing nexus was considered to be physical presence within the state. This standard was supported by the U.S. Supreme Court's decision in *National Bellas Hess Inc. v. Department of Revenue of Illinois*, 386 US 753, L.ed 2d 505, 87 S Ct 1389 (1967):

In *National Bellas Hess*, the state of Illinois attempted to impose a use tax on the Illinois sales of an out-of-state mail order house whose only contacts with the state were via the mail or common carrier. Catalogues and advertising flyers were mailed to customers in Illinois. The customers mailed merchandise orders to the Missouri headquarters, and the goods were then sent to the customers either by mail or by common carrier.

The Court stated that allowing states and other jurisdictions to impose use tax burdens based upon such minimal connections could entangle interstate businesses in a "virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose `a fair share of the cost of the local government'". The Court concluded that the mail order house did not have sufficient nexus in Illinois, and the requirement that they collect and pay the Illinois use tax therefore violated the due process and commerce clauses.

More recently however, the U.S. Supreme Court revisited the issue and issued a decision that suggests that physical presence may not always be necessary for nexus:

Quill Corp v. North Dakota (112 S.Ct. 1904, 119 L.Ed.2d 91 (1992)), involved whether a mail order house had sufficient nexus within North Dakota for that state to impose a use tax. The facts in this case were similar to those in *National Bellas Hess*. Quill solicited its sales of office equipment through catalogs and flyers, advertisements in national periodicals, and telephone calls. All of its merchandise was delivered to its North Dakota customers by mail or common carrier from out-of-state locations. Quill's only property within the state consisted of computer software programs that were licensed to some of its North Dakota customers that enabled them to check on Quill's current inventories and prices and to place orders directly (the trial court found this physical connection to be insignificant for nexus purposes).

The Court explained that the Due Process Clause concerns the fundamental fairness of government and requires (1) "some definite link, some minimal connection, between a state and the person, property or transaction it seeks to tax," and (2) that the "income attributed to the State for tax purposes must be rationally related to values connected with the taxing state." The Court held that the minimum connection would exist so long as an out-of-state corporation purposefully availed itself of the benefits of an economic market in the taxing state, even if it had no physical presence in the state. Since Quill had purposefully directed a substantial amount of its activities at North Dakota residents, it was clearly receiving benefits from its access to the state, and clearly had fair warning that its activity may be subject to North Dakota's jurisdiction. The Court therefore found that North Dakota's use tax did not violate Due Process.

In contrast to the "minimum connections" test for due process, the Court observed that the test under the Commerce Clause was a "substantial nexus" test. The Commerce Clause was intended to be a means of limiting state burdens on interstate commerce. In this context, the Court found the physical presence test of Bellas Hess to be appropriate. The artificiality of the bright-line physical presence rule was found to be more than offset by the benefits of firmly establishing boundaries of legitimate state authority. Furthermore, the *Bellas Hess* physical presence standard for state sales and use taxes had become part of the basic framework of the mail order industry. In the interest of "stability and orderly development of the law," the Court upheld physical presence as the relevant standard for substantial nexus under the Commerce Clause. The Court concluded that the facts in Quill did not constitute substantial nexus.

The implication of this decision on state franchise taxes is unclear. Although the Court admitted the physical presence standard to be artificial, they did not find that fault to be compelling enough to reject the long-standing rule that *Bellas Hess* had established in the area of sales and use taxes. Since there is no Supreme Court precedent on this issue for franchise tax purposes, an argument may be made that a less artificial standard should apply for franchise tax purposes. The South Carolina Supreme Court in Geoffrey, discussed below, has taken this position.

(437 S.E.2d 13 (1993), Cert. Denied, U.S. S.Ct., 11/29/93) was a South Carolina state income tax case involving the existence of nexus. Geoffrey was a Delaware company with no offices, employees or tangible property in South Carolina. Geoffrey executed a license agreement, which gave its parent, Toys R Us Inc., the right to use the "Toys R Us" trade name (as well as other trade names, trademarks, merchandising skills, techniques and know-how) in all but five states. In consideration for the licenses, Geoffrey received a royalty of 1% of the net sales of Toys R Us, Inc. Subsequent to the agreement, Toys R Us began doing business in South Carolina, and made royalty payments to Geoffrey based upon their sales in that state. The State of South Carolina assessed income tax on Geoffrey's royalty income. Geoffrey filed a claim for refund, arguing that it did not have sufficient nexus in South Carolina for its royalty income to be taxable there. The South Carolina Supreme Court disagreed, holding that Geoffrey's presence in South Carolina satisfied both the Due Process and Commerce Clause tests.

Geoffrey had asserted that it had not purposefully directed its activity at South Carolina, pointing out that Toys R Us had no South Carolina stores when the license agreement was executed and that the subsequent expansion was purposeful on the part of Toys R Us, not Geoffrey. The Court responded that by electing to license its trademarks for use by Toys R Us in many states, Geoffrey contemplated and purposefully sought the benefit of economic contact with those states. By licensing intangibles for use in South Carolina and receiving income in exchange for their use, Geoffrey was found to have the minimum connection required by due process.

The Court also found the "minimum connection" to have been satisfied by the presence within the state of Geoffrey's intangible property (the agreement resulted in a franchise in South Carolina; and when Toys R Us made sales, accounts receivable were generated for Geoffrey). With respect to the due process requirement that the tax be rationally related to benefits that have been conferred, the Court stated that by providing an orderly society, South Carolina had made it possible for Geoffrey to earn income from Toys R Us customers in that state.

In analyzing the Commerce Clause aspects of the case, the Court reiterated that the physical presence requirement of *Quill* was decided in the context of a use tax, and did not consider the issue for purposes of a franchise or income tax. The Court therefore did not consider physical presence to be the standard in this case, and concluded that by licensing intangibles for use in the state and by deriving income from their use there, Geoffrey had substantial nexus with South Carolina.

Note: Geoffrey is a South Carolina case and may not be cited as precedent for California purposes. The case is instructive, however, because it indicates how at least one Court has interpreted *Quill*.

Clearly, a significant physical presence within a state will be enough to constitute nexus under both the Due Process and Commerce Clauses. The level of physical presence that is required is not as clear. For example, the existence of some floppy disks within the state was not found to be significant in Quill. If an auditor is asserting nexus in a case where the physical connections are arguably minor, the audit narrative should explain the importance of those connections to the business activity.

Constitutional nexus standards have been the subject of a good deal of controversy lately because of the new ways that business is being conducted in today's electronic age and because of recent court decisions that suggest that the traditional concepts of nexus may be expanding. Some of the controversy involves nexus through agency relationships. Another area of speculation centers around the level of physical presence that is required to establish nexus, and the possibility that nexus standards may be expanding to the point where nexus can exist for state franchise or income tax purposes in some situations even without the taxpayer having a physical presence within the state.

The trend in the courts appears to be a de-emphasis of the physical presence requirements in recognition of the changing business environment. For example, in the New York Court of Appeals cases of Orvis Company, Inc. and Vermont Information Processing, Inc. (86N.Y.2d 954 (1995)), the court stated that the "substantial *nexus*" that is required in order for a state to have jurisdiction to tax under the Commerce Clause does not necessarily mean "substantial *physical presence*." In the facts of those cases, the Vermont corporations marketed products to New York through mail order and had a substantial customer base in New York. Although visits by employees of the corporations to New York were described by the taxpayers as sporadic and occasional, the court believed that those visits significantly enhanced sales and benefited the business. Therefore, because there was a substantial economic presence in New York, the fact that the level of physical presence was "more than a slightest presence" was considered enough to establish nexus. (Note that these were sales tax cases, so Public Law 86-272 did not apply.)

The Orvis and Vermont Information Processing cases were decided in a New York court and do not establish precedent for California, but the analysis used by the court may be helpful to an auditor attempting to establish nexus. For example, if a foreign corporation makes sales to a California destination and that the corporation's ties to the state are at least as strong as the ties that Orvis and Vermont Information Processing had with New York, then the auditor could use the rationale explained in the decision to assert that nexus has been established.

When a California taxpayer makes sales to a foreign destination, auditors are usually looking at the nexus issue from the opposite perspective because the sales may only be thrown back to California if the corporation does not have nexus in the foreign jurisdiction. Auditors should consider the *Orvis* and *Vermont Information Processing* cases in determining the strength of the taxpayer's connections in the foreign country. Remember, however, that the case law is still developing in this area so there is no bright-line threshold. If the auditor does not believe that substantial nexus has been established in the foreign country, it will be important to fully develop all of the facts and clearly explain the rational supporting the nexus determination.

In some cases, nexus may be established by activities of an agent rather than by activities of the taxpayer. This issue is discussed in MATM 1110.

When a taxpayer is first entering a taxing jurisdiction or when the taxpayer's activities within a jurisdiction are increasing, it may be necessary to establish the date upon which nexus was established. Although a taxpayer may establish nexus during the taxable year, the state will not have authority to tax income earned prior to the date upon which nexus was achieved. An example of this concept may be found in MATM 1210.

When considering the materiality of a nexus issue, auditors must remember to take into account the effects of P.L. 86-272 limitations and other exemptions from tax (such as the exemptions for insurance companies -- see MATM 3085). If a corporation will be immune from state taxation under

P.L. 86-272, nexus will be a mute point. In situations that do not involve sales of tangible personal property, P.L. 86-272 will not apply, but the sales factor rules will need to be carefully considered in order to determine whether nexus within a particular state will have a significant tax effect. For example, even if a corporation derives income from intangible property used within the state, that income may only be included in the sales factor if the greatest proportion of the income producing activity occurs within the state (see MATM 7560). Without factor representation to assign income to California, the establishment of nexus may not result in any more than the minimum tax.

Reviewed: December 2002

1110 Nexus Through An Agency Relationship

Activities performed within a state may establish nexus even if an agent of the taxpayer, instead of by the taxpayer itself, performs those activities. The fact that an agent performs activities does not diminish the fact that the taxpayer is realizing benefits from within the state. Even the fact that the agent might also work for other principals is unimportant (although only the activities performed on behalf of the taxpayer may be considered in determining whether the threshold for nexus has been met). The relevant test for determining nexus therefore focuses on the nature and extent of the activities within a state, regardless of whether those activities are performed directly by the taxpayer or by an agent on the taxpayer's behalf. (*Scripto Inc. v. Carson, 362 U.S. 207* (1960); *Illinois Commercial Men's Association v. State Board of Equalization*, (1983) 34 Cal.3d 839; *Dresser Industries, Inc*., Cal. St. Bd. of Equal., Opinion on Petition for Rehearing, October 26, 1983).

California Civil Code §1793.2 provides that every manufacturer of consumer goods sold within California with express warranties must maintain repair facilities reasonably close to the sales location. To comply with this provision, the warranty work can be subcontracted to an independent third party. Since performing warranty work through a subcontractor may be enough to establish taxability within the state, auditors should request copies of the manufacturer's warranty provisions. In addition, the auditor should determine how the warranties are honored and if the repairs are subcontracted or not. Copies of contracts for subcontracting of warranty services should be requested. The U.S. Supreme Court has held that the in-state presence of a representative of an out-of-state seller who conducts regular and systematic activities in furtherance of the seller’s business, creates nexus (*Scripto Inc. v. Carson*, 362 U.S. 207 (1960); *General Trading Corp. vs. Iowa*, 322 U.S. 327 (1966); *Tyler Pipe Industries, Inc. vs. Washington Department of Revenue*, 483 U.S. 232 (1987)). Depending on the facts of an audit, the out-of-state manufacturer may have nexus in California by providing for repair facilities.

Corporations will often act as agents for unitary affiliates. For example, assume that Corporations A and B are unitary. Corporation A manufactures power tools in Wisconsin, and has no employees and engages in no direct activities in California. Corporation B is a building supply distributer operating in California. When B's employees solicit sales from building supply retailers in California, they also solicit sales of power tools on behalf of Corporation A. When power tool orders are taken, the orders are forwarded to Corporation A, and B's employees receive a commission. Corporation B's activities in California on A's behalf will cause A to have nexus within this state.

The Courts have been fairly liberal in finding an agency relationship to exist, as is illustrated in the following case:

In *Scholastic Book Clubs, Inc. v. State Board of Equalization*, (1989) 207 Cal.App.3d 734, the taxpayer had no property or employees in California. It conducted business by mailing catalogs to

teachers and librarians in schools throughout the United States. Each catalog included "offer sheets" for the teachers to distribute to their students, but the teachers were under no obligation to do so. The teachers would consolidate the orders and payments made by their students, and submit them to the taxpayer. Orders were filled and shipped from a Missouri warehouse to the teacher, who then distributed the materials to the students. To encourage teachers to place orders, the taxpayer gave them "bonus points" based upon the size of their orders. The bonus points could be used to obtain merchandise from a gift catalog.

The taxpayer argued that they had no real agency relationship with the teachers, therefore the activities of the teachers should not cause the taxpayer to have nexus within California. The Court disagreed, finding the relevant fact to be that the teachers served the function of obtaining sales within California from local customers. The Court noted that the taxpayer depended on the teachers to act as its conduit to the students. Moreover, the Court found an implied contract to exist between the taxpayer and the teachers as evidenced by the fact that the taxpayer rewarded the teachers with bonus points if they obtained and processed orders. The taxpayer attempted to minimize the payment of bonus points by claiming that the teachers could not earn their living through bonus points. The Court responded by stating that "neither the form of the remuneration, the amount thereof, nor the fact that the teachers and librarians were not formally employed by, or dependent upon appellant for their primary income has any legal significance in determining whether they acted as appellant's representatives in soliciting orders for appellant's products in California." The Court held that the taxpayer was exploiting or enjoying the benefit of California's schools and employees to obtain sales, and thus had nexus within the state.

Reviewed: December 2002

1120 Free Trade Zones

Corporations that operate in a Free Trade Zone (also called Foreign Trade Zones) within California are not exempt from Franchise or Income tax. Corporations can warehouse, assemble and manufacture goods within a Free Trade Zone. Such goods are exempt from U.S. customs duties and federal excise taxes until sent from the zone.

As a general rule, storing property within the state will be sufficient to establish taxable nexus. The value of such property is then included in the numerator of the property factor of the taxpayer's apportionment formula for this state. Note that if inventory is simply warehoused in this state for a brief period of time awaiting further transportation of the goods to the ultimate destination (e.g the goods pass through the state as part of a "stream of commerce"), generally neither the inventory nor the sale would be assignable to this state. Alternatively, if the purchaser takes possession (or constructive possession through an agent or bailee) so that the goods leave the stream of commerce within this state, such as for inspection or minor assembly work, the inventory and the sale are assignable to this state. For a further discussion of this issue, see *Appeal of Mazda Motors, Inc*., Cal. St. Bd. Of Equal., November 29, 1994. Also see Legal Ruling 95-3, July 20, 1995 and *McDonnell Douglas v. Franchise Tax Board* (1994) 26 Cal. App. 4th 1789.

Reviewed: September 2003

1200 PUBLIC LAW 86-272

Public Law 86-272 was enacted by Congress as of September 14, 1959 to prohibit states from imposing an income tax upon a taxpayer whose only activity within a state is solicitation of orders for the sale of tangible personal property (15 USCA §381). Since such activity is generally sufficient to establish nexus (MATM 1100), the business community was concerned that interstate commerce would be burdened because businesses would be subject to tax in many states in which they had minimal activities. Public Law 86-272 was enacted in response to this concern. Public Law 86-272 established the following provision in the U.S. Code:

TITLE 15: COMMERCE AND TRADE
CHAPTER 10B: STATE TAXATION OF INCOME FROM INTERSTATE COMMERCE -- NET INCOME TAXES
§381

No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, the following:

the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

The provisions of subsection (a) shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to --

any corporation which is incorporated under the laws of such state, or

any individual who, under the laws of such State, is domiciled in, or a resident of, such State.

For purposes of subsection (a), a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

For purposes of this section --

The term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities; and the term "representative" does not include an independent contractor.

Reviewed: December 2002

1210 Key Provisions Of Public Law 86-272

Immunity in a state does not apply to any corporation incorporated within the state. (Note that a corporation will be eligible for immunity if it is qualified to do business in the state, so long as it is not incorporated there. Since immunity only applies to taxes based on net income, a taxpayer qualified to do business in California would still be liable for the minimum tax.)
Immunity under P.L. 86-272 only applies to sellers of *tangible personal property*. Activities related to sales of real estate or intangibles, to the leasing, renting, or licensing of property, to the provision of services, or to any other transactions not specifically protected under P.L. 86-272 will cause a loss of immunity.

Activity within the state must not go beyond solicitation of orders for sales of tangible personal property. (An exception is made for de minimis activities.) Activities that are considered to fall within the meaning of "solicitation" are discussed in MATM 1220.

Approval of the orders must be made outside the state.

Deliveries to customers must be made from a point outside the state.

Certain in-state activities conducted on behalf of the taxpayer by an independent contractor will not cause loss of immunity even though such activities would not be allowed if performed by the taxpayer directly. This topic is covered in more detail in MATM 1230.

A single event during the taxable year can cause the loss of immunity for the entire year so long as the taxpayer had nexus within the state. If nexus is established mid-year, then the taxpayer would not be taxable prior to the date of nexus. The following example will illustrate this concept:

Example:

ABC Corporation is a manufacturer of recycling equipment headquartered in Arizona. ABC made sales to California customers throughout 1994, but from January to June the sales were ordered over the telephone by the California customers, and were shipped by common carrier from the Arizona headquarters. ABC had no other connections with California during this time period. On July 1, 1994, ABC assigned an employee to live in California and solicit sales from California customers (this act established nexus). On December 1, ABC's employee exceeded the activities allowed under P.L. 86-272 by assembling a large recycling system at a customer's California location.

Although the employee's activity on December 1 caused loss of immunity under P.L. 86-272 for the entire year, ABC did not have nexus in California until July 1. Assuming that ABC is a calendar year taxpayer, California would have the right to tax ABC on its income attributable to California sources

from July 1 to the end of the year.

The loss of immunity in one year does not carry over to a subsequent year. Therefore, if the employee's activities did not exceed allowable solicitation during 1995, ABC would again be immune from California tax in that year.

P.L. 86-272 only applies to interstate commerce and not to foreign commerce. See MATM 1240 for further discussion of this issue.
(a) Taxability in any particular state under P.L. 86-272 must be determined separately for each corporation in the combined group. Thus, the activities of one member of the combined group may not cause loss of immunity for another member. (An exception may arise when one member of the combined report acts as a representative or independent contractor for another member (see MATM 1230).)

(b) For sales factor purposes, sales to a state in which the taxpayer is immune from taxability under P.L. 86-272 will be "thrown-back" to the state from which the goods were shipped (MATM 7530). For apportionment purposes only however, if any member of the combined group is taxable in the destination state, then the sales will be included in the combined group's sales factor numerator for that state (MATM 7530 & MATM 7905).

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1220 "Solicitation Of Sales" Defined

In *Wisconsin Department of Revenue v. William Wrigley Jr., Co*., 112 S.Ct. 2447, 120 L.Ed.2d 174 (1992), the U.S. Supreme Court established a standard for interpreting the term "solicitation." Under that standard, "solicitation of orders" means activities that are essential or entirely "ancillary" to making requests for orders.

The Court explained ancillary activities to be those activities that serve no independent business function apart from their connection to the soliciting of orders. If a company would engage in certain activities for reasons other than solicitation, the fact that they have assigned those activities to salespersons does not make the activities ancillary to solicitation of orders. The Court presented the following example:

"*Providing a car and a stock of free samples to salesmen is part of the `solicitation of orders' because the only reason to do it is to facilitate requests for purchases. Contrariwise, employing salesmen to repair or service the company's products is not part of the `solicitation of orders,' since there is good reason to get that done whether or not the company has a sales force. Repair and servicing may help to increase purchases; but it is not ancillary to requesting purchases, and cannot be converted into `solicitation' by merely being assigned to salesmen.*"

Another example of how the Courts have limited the interpretation of "solicitation of orders" to mean activities directly related to making requests for orders is shown in the following case:

In *Brown Group Retail v. Franchise Tax Board*, 44 Cal.App.4th 823 (1996), the taxpayer sold shoes to independent retailers. In addition to sales personnel who solicited sales within California, the taxpayer also employed two individuals within the state whose function was to help shoe retailers establish and enhance their stores. This involved providing assistance and advice regarding everything from site selection and store lease negotiations to improving inventory turnover, trimming windows and setting up bookkeeping systems. These services were provided free of charge, and the employees who provided the services were not allowed to take orders for sales. The purpose for providing these services was to increase the retailers' sales, which would in turn benefit the taxpayer. The Court held that while this activity was ultimately intended to increase the taxpayer's sales, it did not facilitate requests for sales. Therefore, it was not a protected activity under P.L. 86-272.

The language of P.L. 86-272 (15 USCS §381(c)) implies that maintenance of an office within the state goes beyond solicitation, even if that office is maintained exclusively to facilitate requests for purchases. In the *Wrigley* case however, the Court distinguished between offices that are formally attributed to the company, and in-home offices used by sales personnel to complete paperwork or hold occasional meetings. The in-home offices maintained by Wrigley's salespeople were found to serve no purpose apart from their role in facilitating solicitation, and so did not cause loss of immunity.

The Court in *Wrigley* also concluded that a de minimis exception should be applied. Even if a taxpayer performs activities within a state that are not "ancillary to solicitation," those activities should not cause the taxpayer to lose immunity if they are de minimis or trivial. In determining whether such activities are trivial enough to be considered de minimis, the nonprotected activities should not be looked at individually, but should be considered as a whole. The facts in *Wrigley* serve as an illustration of how the de minimis exception should be applied:

In *Wrigley*, the Court found the following activities of the taxpayer to go beyond solicitation of orders: (1) replacement of stale gum in customers' displays; (2) "agency stock checks" (This consisted of directly selling gum to fill customers' display racks); and (3) storage of gum within the state for the primary purpose of stale gum replacement and agency stock checks. The taxpayer argued that these activities were minimal, and emphasized that the gum sold in agency stocks accounted for only .00007% of Wrigley's annual sales within that state, and amounted to only several hundred dollars a year. The Court did not agree that the activities were de minimis:

"*We need not decide whether any of the nonimmune activities was de minimis in isolation; taken together, they clearly are not. Wrigley's sales representatives exchanged stale gum, as a matter of regular company policy, on a continuing basis, and Wrigley maintained a stock of gum worth several thousand dollars in the State for this purpose as well as for the less frequently pursued (but equally unprotected) purpose of selling gum through `agency stock checks'. Although the relative magnitude of these activities was not large compared to Wrigley's other operations in Wisconsin, we have little difficulty concluding that they constituted a nontrivial additional connection with the State."*

The Multistate Tax Commission has adopted guidelines for applying P.L. 86-272 that reflect the standards established by the *Wrigley* decision. Contained in those guidelines are examples of activities that are generally considered to exceed solicitation, as well as examples of protected activities. Auditors should keep in mind that these rules are not intended to cover all possible situations. Each case will have to judged on its own facts. More importantly, those facts must be considered in the context of the taxpayer's activities within the state as a whole.

Examples of Unprotected Activities:
The following activities are not generally considered to constitute solicitation of orders or to be ancillary to solicitation, and are not otherwise protected under P.L. 86-272. If the performance of any of these activities within a state exceeds a de minimis level, immunity under P.L. 86-272 may be lost.

- Making repairs or providing maintenance or servicing. (The SBE confirmed that performing warranty repairs within the state went beyond solicitation of orders in *Appeal of Aqua Aerobic Systems, Inc*., Cal. St. Bd. of Equal., 11/6/85.)
- Collecting current or delinquent accounts, whether directly or through third parties.
- Investigating credit worthiness.

- Installation of the product, or supervision of installation. (In *Appeal of Riblet Tramway Company*, Cal. St. Bd. of Equal., December 12, 1967, the SBE found that a contractual right to inspect and approve the installation of a product will also cause loss of immunity.)
- Conducting training courses, seminars or lectures for personnel other than personnel involved only in solicitation.
- Providing any kind of technical assistance or service including engineering assistance or design service, when one of the purposes thereof is other than facilitating the solicitation of orders.
- Investigating, handling, or otherwise assisting in resolving customer complaints, other than mediating direct customer complaints when the sole purpose of such mediation is to ingratiate the sales personnel with the customer.
- Approving or accepting orders.
- Repossessing property.
- Securing deposits on sales.
- Picking up or replacing damaged or returned property.
- Hiring, training, or supervising personnel, other than personnel involved only in solicitation.
- Using agency stock checks or any other process by which sales are made within the state by sales personnel.
- Maintaining a sample or display room in excess of two weeks at any one location within the state during the tax year.
- Carrying samples for sale, exchange or distribution in any manner for consideration or other value.
- Owning leasing, using or maintaining any of the following facilities or property in-state:
- Repair shop.
- Parts department.
- Any kind of office other than an in-home office as described below.
- Warehouse.
- Meeting place for directors, officers, or employees.
- Stock of goods other than samples for sales personnel or that are used entirely ancillary to solicitation.
- Telephone answering service that is publicly attributed to the company or to employees or agents of the company in their representative status.
- Mobile stores (vehicles with drivers who make sales from the vehicles).
- Real property or fixtures to real property of any kind.
- Consigning stock of goods or other tangible personal property to any person, including an independent contractor, for sale.
- Maintaining, by any employee or other representative, an office or place of business of any kind. An exception to this general rule applies only with respect to an in-home office located within the residence of the employee or representative that is not publicly attributed to the company. Even then, the use of such an in-home office is limited to soliciting and receiving orders from customers, for transmitting such orders outside the state for acceptance or

rejection by the company, or for other activities that are protected under P.L. 86-272. For this purpose, it is not relevant whether the company pays directly, indirectly, or not at all for the cost of maintaining the in-home office.

A company will normally be determined to be maintaining an office or place of business within the state if they have a telephone listing or other public listing within the state (including a listing for an employee or representative if the listing identifies them in their representative capacity). Similarly, advertising or business literature that indicates that the company or its employee or representative can be contacted at a specific address within the state shall normally be construed as the company maintaining an office or place of business within the state. However, the normal distribution and use of business cards and stationary identifying the employee's or representative's name, address, telephone and fax numbers and affiliation with the company shall not, by itself, be considered as advertising or otherwise publicly attributing an office to the company or its employee or representative.
Entering into franchising or licensing agreements; selling or otherwise disposing of franchises and licenses; or selling or otherwise transferring tangible personal property pursuant to such franchise or license.
Shipping or delivering goods into this state by means of private vehicle, rail, water, air or other carrier, irrespective of whether a shipment or delivery fee or other charge is imposed, directly or indirectly, upon the purchaser.
Conducting any other activity, which is not entirely ancillary to requests for orders, even if such activity helps to increase purchases.

Examples of Protected Activities:
The following activities will not cause the loss of immunity:

- Soliciting orders for sales by any type of advertising.
- Soliciting of orders by an in-state resident employee or representative of the company, so long as such person does not maintain or use any office or other place of business in the state other than an "in-home" office as described in #18 above.
- Carrying samples and promotional materials only for display or distribution without charge or other consideration.
- Furnishing and setting up display racks and advising customers on the display of the company's products without charge or other consideration.
- Providing automobiles to sales personnel for their use in conducting protected activities.
- Passing orders, inquiries and complaints on to the home office.
- Missionary sales activities (the solicitation of indirect customers for the company's goods). For example, a manufacturer may sell only to wholesalers, but it may solicit retailers to buy its products from the wholesale customers. Such solicitation would be protected.
- Coordinating shipment or delivery without payment or other consideration.

- Checking of customer's inventories without charge (for reorder, but not for other purposes such as quality control).
- Maintaining a sample or display room for two weeks or less at any one location within the state during the tax year.
- Recruiting, training or evaluating sales personnel, including occasionally using homes, hotels or similar places for meetings with sales personnel.
- Mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating requests for orders.

Owning, leasing, using or maintaining personal property for use in the "in-home" office or automobile of an employee or representative, so long as the use of the property is solely limited to the conducting of protected activities. Therefore, maintaining personal property such as cellular telephones, facsimile machines, duplicating equipment, personal computers and computer software shall not, by itself, remove the protection of P.L. 86-272 as long as such equipment is used only to carry on protected solicitation and activity entirely ancillary to such solicitation.

Reviewed: December 2002

1230 Activities Of Independent Contractors

P.L. 86-272 extends protection to certain in-state activities if an independent contractor conducts them, even though immunity would be lost if those same activities were conducted directly by the taxpayer. Independent contractors may engage in the following limited activities within the state without causing the taxpayer to lose immunity:

1. Soliciting sales;
2. Making sales; and
3. Maintaining an office.

Except for purposes of display however, the taxpayer may not maintain any inventory or stock of goods within the state under consignment with the independent contractor. Maintenance of such inventory will cause loss of immunity.

Sales representatives who represent a single principal are not considered to be independent contractors, and are subject to the same limitations as an employee.

In *Appeal of Nardis of Dallas, Inc*., Cal. St. Bd. of Equal., April 22, 1975, a salesman solicited orders in California for a Texas-based company, and maintained a showroom within California for that purpose. The taxpayer argued that the salesman was an independent contractor; therefore the maintenance of the showroom should be a protected activity under P.L. 86-272. The SBE disagreed, stating that the salesman was not an independent contractor under the tests developed at common law. Factors that the SBE found to be significant in determining that an employer/employee relationship existed included the taxpayer's right to discharge the salesman upon notice, and the fact that the parties themselves believed that they had created an employment relationship, as evidenced by the payment of unemployment taxes. As an employee of the taxpayer, maintenance of the showroom went beyond the minimum activities allowed under P.L. 86-272.

Reviewed: December 2002

1240 Public Law 86-272 Does Not Apply To Foreign Commerce

The immunity provided by Public Law 86-272 is expressly limited to interstate commerce. No such immunity applies with respect to foreign commerce. Although CCR §25122(c) states that U.S. jurisdictional standards shall be applied to determine whether a foreign country has jurisdiction to subject a taxpayer to tax, the SBE has held that this refers to U.S. Constitutional nexus; jurisdictional limitations of P.L. 86-272 are not considered. (*Appeal of Dresser Industries, Inc*., Cal. St. Bd. of Equal., June 29, 1982.)

If sales are made from California to a foreign destination, the relevant question is whether the taxpayer has constitutional nexus in the foreign country using the standards discussed in MATM 1100 and MATM 1110. If nexus is determined to be present, the sales may not be thrown back to the California sales factor numerator (see MATM 7530) even if the taxpayer's activities within that country do not go beyond solicitation of orders for sales.

Conversely, if sales are made from a foreign country to a California destination, the sales will be included in the sales factor numerator as long as the taxpayer has constitutional nexus within California. P.L. 86-272 will not apply, and the taxpayer will be taxable on their California income regardless of whether their California activities exceed solicitation of orders. This issue may arise when foreign entities with nexus within the state make sales directly to customers within the U.S. (as opposed to indirect sales through a domestic sales affiliate). Information from the foreign entities will usually have to be requested if the auditor suspects that this issue exists.

Reviewed: December 2002

1300 CORPORATION FRANCHISE TAX

The corporation franchise tax is found in Chapter 2 of the Bank and Corporation Tax Law. This tax is paid for the privilege of doing business within California, and the amount of the tax is the greater of (1) the franchise tax under R&TC §23151 or the (2) the minimum franchise tax under R&TC §23153.

A minimum franchise tax is imposed on all corporations, which are incorporated or qualified to do business in this state, which are not expressly exempted under the Bank and Corporation Tax Law (such as credit unions or charitable organizations) or the Constitution of California (such as insurance companies). The minimum tax is a flat fee that is imposed regardless of whether the corporation is active, inactive, operates at a loss, or files a short period return. Effective January 1, 1994, the minimum franchise tax is also imposed on limited partnerships doing business within the state or which have filed a certificate of limited partnership with the Secretary of State (R&TC §23081). The amount of the minimum tax is generally $800 for taxable years beginning on or after January 1, 1990 (R&TC §23153).

The franchise tax is imposed upon all banks and corporations "doing business" in California. See MATM 1310 for a definition of "doing business." This is a prepaid tax that is measured by the net income of the preceding year (the "income year") for the privilege of doing business in the following year (the "taxable year"). The rate of tax for general corporations is prescribed by R&TC §23151.

Reviewed: December 2002

1310 "Doing Business" For Purposes Of The Franchise Tax

The term "doing business" is defined in R&TC §23101 to mean "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." A very limited exception to this standard is provided by R&TC §23101.5 if a corporation's only activities within the state are either:

the purchase of personal property or services solely for its own use (or for use by its affiliate) outside the state, provided that certain restrictions regarding the presence of employees within the state are met; or
the presence of employees in the state solely for the purpose of attending a public or private school, college or university.

In addition, R&TC §23102 provides that a holding company organized to hold stock or bonds will not be considered to be "doing business" if its *only* activities are the receipt of dividends or interest, and the disbursement of those receipts to shareholders. To qualify under this exception, the holding company may not engage in trading the stock, bonds or other securities that it holds.

If a partnership is doing business within the state, then all of the general partners of that partnership are also considered to be doing business within the state. However, in the *Appeal of Amman & Schmid Finanz AG, et. al*., Cal. St. Bd. of Equal., April 11, 1996, the SBE held that a limited partner would not be considered to be doing business merely because it owned a limited partnership interest in a partnership that was doing business within the state.

Outside of these limited exceptions, the definition of "doing business" is very broad. Also, since the language of R&TC §23101 refers to "any" transaction, it is not necessary that the corporation conducts business or engages in transactions within the state on a regular basis. An isolated transaction during the year may be enough to cause the corporation to be doing business (see Carson Estate Co. v. McColgan, 21 Cal.2d. 516). Even negotiations that are an integral part of entering into a transaction may be considered to be doing business (*Appeal of Ebee Corp., Taxpayer, and Bacciocco, Assumer and/or Transferee*, Cal. St. Bd. of Equal., February 19, 1974).

There have been several Court and SBE decisions dealing with activities that will constitute doing business, and when a commencing or liquidating corporation will be considered to be doing business. Many of these cases are listed in the annotations under R&TC §23101. Auditors faced with these issues should consult those cases as well as the regulations under R&TC §23101.

Reviewed: December 2002

1320 Determining Whether The Franchise Tax Applies

The first step in ascertaining California's power to tax a corporation is to determine whether there is constitutional nexus to tax (MATM 1100). If so, and if interstate commerce is involved, then the auditor must determine whether the activities within the state fall under the immunity offered by P.L. 86-272 (MATM 1200 - MATM 1240). Finally, if the corporation is determined to be taxable in California after the first two steps, the auditor must determine whether the taxpayer is doing business within the state in the context of R&TC §23101. If so, then the taxpayer will be subject to the franchise tax under Chapter 2 of the Bank & Corporation Tax Law. If the taxpayer is not doing business in California, but derives income from sources within the state, then the corporation income tax under Chapter 3 of the Bank & Corporation Tax Law will be imposed. The corporation income tax will be discussed below.

Reviewed: December 2002

1400 CORPORATION INCOME TAX

Under Chapter 3 of the Bank and Corporation Tax Law, an income tax is imposed on all corporations which, while not "doing business" in California, do "derive income from sources within this state" (R&TC §23501). "Income derived from or attributable to sources within this State" is defined in R&TC §23040 to include income from tangible or intangible property located or having a situs in California, and income from any activities carried on in this State, regardless of whether carried on in intrastate, interstate, or foreign commerce.

For taxable years beginning on or after January 1, 1993, R&TC §23040.1 provides an exception to the general definition of "income derived from or attributable to sources within this state" for a partner's distributive share from an investment partnership of interest, dividends, and gains from the sale or exchange of investment securities. This exception will not apply if the partner or any of its unitary affiliates or partnerships has any income derived from or attributable sources within the state other than qualified investment partnership income. Furthermore, the exception will not apply if the partner or any of its unitary affiliates or partnerships participates in the management of the investment activities of the investment partnership. Additional requirements and definitions regarding this exception are contained in R&TC §23040.1.

In most cases, a corporation with sufficient activities to have nexus within the state will also be considered to be "doing business" within the state, so the franchise tax will be applied. Some examples of when the income tax under Chapter 3 would be applicable are:

When the income from sources within California is derived entirely from passive investments. Even then, the taxpayer will probably be considered to be "doing business" in the years in which they negotiate or enter into transactions to acquire or dispose of the investments.

CCR §23040(b) provides that a foreign (non-California) corporation will be subject to the income tax rather than the franchise tax if its activities within the state are exclusively in interstate or foreign commerce. For example, a foreign corporation will be subject to the income tax if it ships goods from outside the state to fill orders taken by its employees in California (assuming that the corporation is not immune under P.L. 86-272, see MATM 1210). Foreign corporations will also be subject to the income tax if they maintain inventories of goods within the state for the exclusive purpose of filling orders taken by independent dealers or brokers.

On the other hand, if a foreign corporation maintains an inventory in California for purposes of filling orders taken by *employees*, then the corporation is considered to be engaged in *intrastate* business within California, and is therefore subject to the franchise tax.

If a corporation's only connections with this state are as a limited partner in a partnership that is doing business within the state, then that corporation will be subject to the income tax rather than the franchise tax (MATM 1310).

Both the franchise and income taxes are subject to the allocation and apportionment provisions of California law. The primary differences between the two taxes are that:

Corporations subject to the income tax do not have a minimum tax if they are not incorporated or qualified within the state. (If a taxpayer is incorporated or qualified within California however, it will be subject to the minimum franchise tax as well as the income tax. In such cases, R&TC §23503 allows the minimum franchise tax to be offset against the income tax.)

U.S. government income is exempt from income tax. (Since the franchise tax is not a tax on net income, but is only *measured* by income, U.S. government income may be included in the tax base for the franchise tax. MATM 6065.)

Reviewed: December 2002

1500 COMMERCIAL DOMICILE

Certain items of nonbusiness income from intangibles, such as interest and dividend income, are allocated to the state in which the corporation's commercial domicile is located. The commercial domicile of a corporation is defined in R&TC §25120(b) to mean the principal place from which the trade or business of the taxpayer is directed or managed (also see CCR §23040(a)). The commercial domicile may be distinguished from the legal domicile, which is merely the state of incorporation.

In most cases, the commercial domicile of a corporation will be the state in which the headquarters or principal offices are located. In some situations however, it will not be as easy to identify where the actual control of the corporation took place, and the auditor will have to analyze the facts and circumstances. The SBE pointed out some of the relevant factors to consider in the following decision:

In *Appeal of Norton Simon, Inc*., Cal. St. Bd. of Equal., March 28, 1972, the taxpayer had formerly been engaged in the manufacture of plywood in Washington. Although it had sold most of its plywood operations by the appeal years, the taxpayer still held some interests and rights related to those operations and oversaw the management of those rights. The taxpayer's only office was in Washington. The taxpayer also had a large investment portfolio that was managed by an executive committee of the Board of Directors in California. Because of the magnitude of its investment activity in relation to its remaining plywood-related activity, the SEC required the taxpayer to register as an investment company. Although the certificates evidencing the taxpayer's investments had originally been kept in a safe-deposit box in California, the executive committee transferred the certificates to Washington in order to avoid becoming subject to California tax.

The taxpayer argued that its commercial domicile was in Washington for the following reasons: (1) its officers and employees were Washington residents; (2) its books and records were located in Washington; (3) most of its intangible assets were located in Washington; (4) its stockholders met in Washington, (5) it filed its federal returns in Washington; and (6) it owned timber rights and security interests in property in that state.

Although the SBE acknowledged that the facts relied upon by the taxpayer are often mentioned in case law as tending to establish a commercial domicile, the SBE went on to state that those facts are not decisive in this particular case. During the appeal years, the taxpayer's entire income was from its investment activities, and the executive committee in California managed those activities. Although the executive committee met only once in a two-year period, they were responsible for the day-to-day investment decisions on an informal basis. Stating that the "essence of the concept of commercial domicile is that it is the place where the corporate management functions, the place where real control exists with respect to the business activities," the SBE held that the real control of the business had shifted to California when the plywood operations were sold.

In *Appeal of Vinnell Corporation*, Cal. St. Bd. of Equal., May 4, 1978, VIC was incorporated in Panama, and was engaged in construction contracting in several foreign countries. None of its contracting activities were performed in California. Management of the business was conducted through regional offices located overseas. The dominant figure in VIC's management was a California resident, but he exercised his duties as president during his constant travels to the regional offices. All of VIC's directors and 11 of its 16 officers were California residents, and they met periodically in California to review and approve (after the fact) the management decisions made by the overseas officers. VIC also maintained a California bank account for receiving the ultimate profit from the foreign construction work, and maintained a general ledger here. The FTB took the position that although VIC did no business in California, it maintained sufficient contacts in California for this state to be considered the commercial domicile.

The SBE disagreed, pointing out that it is the location of actual control that is important, not the location of *ultimate* control. The evidence in the case indicated that all of VIC's business activities were controlled regionally, and there was no documentation to support a center of active operational control. With respect to the board of directors meetings within the state, the SBE stated that passive acquiescence, after the fact, is not the active management and control required to establish a commercial domicile.

Reviewed: December 2002

1600 OVERVIEW OF LAW SECTIONS PERTINENT TO DETERMINING THE NET INCOME OF A MULTISTATE TAXPAYER

R&TC §25101 Basis of Allocation
Section 25101 provides that when the net income of a taxpayer is derived from or attributable to sources both within and without the state, the tax shall be measured by the net income derived from sources within the state. This section authorizes the determination of California income by reference to the combined income of a group of unitary corporations (*Edison California Stores v. McColgan*, 30 Cal.2d 472; this case involved Section 10, the predecessor to R&TC §25101). Also, the California Supreme Court has stated that the language in this section *requires* the use of formula apportionment when the business activities are conducted both within and outside the state (*Superior Oil Co. v. Franchise Tax Board* (1963) 60 Cal.2d 406, 386 Pac.2d 33). See MATM 3005.

R&TC §25105 Determination of ownership of control
This section provides the ownership requirements for inclusion in a combined report. The ownership requirements changed significantly for taxable years beginning January 1, 1995. See MATM 3050.

R&TC §25106 Income from intercompany dividend distribution
This section provides that dividends paid from one corporation to another shall be eliminated to the extent that those dividends are paid out of combined unitary business income. This section was enacted to prevent income from being taxed more than once as it flowed up through the combined group. See MATM 6032.

At the time that this section was enacted, two cases involving intercompany dividends were being litigated (*Safeway Stores, 3 Cal.3d 745 (1970); Pacific Telephone Co. v. Franchise Tax Board*, 7 Cal.3d 544). It was because of these cases that the last paragraph of R&TC §25106 was included to indicate that no inference in any pending litigation cases was intended to be drawn from enactment of that section.

R&TC §25108 Net operating loss
This section provides the rules for applying the net operating loss provisions to taxpayers filing a combined report or taxpayers with income derived from sources within and outside the state. See MATM 8000.

R&TC §25120 Definitions
Section 25120 contains definitions for terms that are used in the UDITPA §§25120 - 25139.

R&TC §25121 - R&TC §25122 When allocation and apportionment applies
The general rule in §25101 provides that the apportionment and allocation provisions apply to corporations with net income derived from or attributable to sources within this state. Section 25121

restricts this rule somewhat by requiring that income be *taxable* outside California before the apportionment provisions will apply. Section 25122 explains when a taxpayer will be considered to be taxable in another state.

R&TC §25123 - R&TC §25127 Allocation of nonbusiness income
These sections provide the rules for allocation of nonbusiness income. See MATM 4000.

R&TC §25128 - R&TC §25136 Apportionment formula
R&TC section 25128 sets forth the apportionment formula, and R&TC §25129 - R&TC §25136 provide the rules for determining the property, payroll and sales factors. See MATM 7000.

R&TC §25137 Equitable adjustment of standard allocation or apportionment
In cases where the standard apportionment formula does not fairly represent the extent of the taxpayer's business activity in this state, this section permits the taxpayer to petition the Franchise Tax Board for the use of separate accounting, the exclusion or inclusion of one or more factors, or the use of any other method that will more equitably allocate and apportion the taxpayer's income. This section also provides authority for the FTB to require such a deviation from the standard formula. The Regulations under this section provide special formulas that have been developed to apportion income for certain industries. See MATM 7700.

R&TC §24344(b) Interest offset
The interest offset provision assigns interest expense deductible against business and nonbusiness income. See MATM 4065.

R&TC §24402 Dividends already subjected to tax
This section provides for dividends to be deducted by the recipient if California has already taxed the income from which the dividends have been paid. The purpose of this provision is to assure that such income is not taxed more than once. See MATM 6030.

Comparable treatment for dividends paid by insurance companies is provided by R&TC §24410. See MATM 6034.

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